

MEMORANDUM

November 19, 2013

FILED

NOV 20 2013

SECRETARY, BOARD OF
OIL, GAS & MINING

To: Utah Board of Oil Gas and Mining

From: Steve Alder,
Assistant Attorney General



Re: December 4, 2013 Board Hearing Memorandum
In the Matter of Crescent Point Energy U.S. Corp., Docket No. 2013-034, Cause
No. 131-136

I. Introduction

Crescent Point Energy U.S. Corp., (Crescent) wishes to establish 640-acre drilling units, for the subject lands and simultaneously is requesting an order that the consent requirement of directional drilling rule R649-3-11(1.1) not apply.¹ In this regard, this matter is similar to the *Axia Energy LLC's Docket No. 2013-030, Cause No. 270-02* and the *Newfield Production Co., Docket No. 2013-027, Cause No. 139-109* which were heard at the October 23, 2013 Board Hearing. In addition, Crescent is asking that the order allow drilling of up to 16 in-fill wells, that the existing forty-two wells be approved as legally acceptable locations, and that the drilling units to be approved apply retroactively to these forty two well as of the respective dates of first production.

II. Analysis and Discussion

A. Request to deem the consent requirement of the directional drilling rule (and of the exception location rule) inapplicable.

It is not clear to what extent Crescent seeks an exception to the directional drilling rule. The RAA sets forth in its preamble that the "Board expressly order the requirements of Utah Admin. Code Rule R649-3-11(1.1) be deemed inapplicable to any well directionally drilled upon said drilling units *within the allowed set backs requested herein.*" RAA 2-3, emphasis supplied. However, in the prayer for relief, paragraph 3.(d), the RAA asks for an order: "Expressly declaring Utah Admin. Code Rule R649-3-11(1.1) is inapplicable to any directionally drilled well within the said drilling units *as long as the productive intervals* are within the setbacks as outlined in Paragraph (b) above, and with the caveat that, if any uphole completion closer that the set back is subsequently proposed, an exception location approval . . . will be required." (RAA 11, emphasis supplied)

¹ The Board may wish to refer to the Division's October 21, 2013 Memorandum regarding well location and siting rules which is attached for the Board's convenience.

If the request were that the directional drilling rule be ordered inapplicable to directionally drilled wells, *so long as they are drilled within the setbacks* established for the unit, a Board order would still be necessary according to the language of the rule. The ownership may not be uniform and absent an order that the rule is inapplicable, the owners within 460 feet of the well path would still be required to consent to the well or a Board order would be necessary. In such an instance, all correlative rights are protected if the rule is deemed inapplicable since production will be shared by all owners in the unit. It makes sense to waive the rule for such wells regardless of the notice to adjacent owners.

It is assumed that the language in the prayer is the intended relief: that is, that the request is to waive the rule as to all wells *so long as the productive interval* is within the set backs. This makes a significant difference, because then there is the potential (and it is a reasonable assumption) that a directionally drilled well may be commenced from a surface location that is closer than 460 feet from the drilling unit boundary and whose well bore will be less than 460 feet from the boundary prior to its entry into the spaced interval. In such a case, the owners who are required to consent will include owners of mineral interests located outside of the drilling unit. These owners will not share in production. The only means for these owners to be avoid what they may find to be adverse consequence of such a well location is to withhold their consent and object when the Board is asked to approve the location, or to drill an off-setting well.

Because the adjoining owners may have reason to object to the portion of the spacing RAA that asks the Board to waive the provision requiring consent for directionally drilled wells, there is a question as to whether such owners should be given notice of the spacing hearing before the Board can consider such a request. There is also a question as to whether such a notice, if given, would be sufficient prior to knowing where such a well may be proposed.

As was argued in the October 21, 2013 Memorandum, neither the directional drilling nor the exception location rules limit their application to *portions of wells within the spaced or productive interval*. Thus the Board must decide if it should make an exception to the requirements that would otherwise apply. The Board does have authority to waive the rules by virtue of its rules (Utah Admin. Code Rule R649-2-1(2) and (3)(2013)), and its statutory authority to establish well locations (Utah code 40-6-6(5)(d)(2013)). However, such authority to deviate from the general rules is limited by the Board's statutory jurisdiction and delegated powers. There are two major considerations that could limit the Board's authority to deem a general rule inapplicable: (1) the requirement to protect correlative rights while seeking a greater ultimate recovery; *see* Utah Code 40-6-1(2013); *Cowling v. Board of Oil, Gas, and Mining*, 830P.2d 220 (1991); and *Adkins v. Board of Oil, Gas and Mining*, 926 P.2d 880 (1996); and (2) the duty to regulate oil and gas production in compliance with the notice and due process required by the Utah Administrative Procedures Act (Utah Code §§ 63G-4-101 to 601); *see* Utah code § 40-6-10 (1)(a) (2013), Utah Admin. Code Rule R641-100-500; and *Hegarty v. Board of Oil, Gas and Mining*, 57 P.3d 1042 (2002).

1. Protection of correlative rights of the adjacent owner.

Is the owner of minerals within 460 feet of a well location, who is otherwise required to give written consent to the drilling of a directional well, entitled to notice of a Board hearing where that right to written consent may be withdrawn? Petitioners argue that notice is not required since correlative rights are protected because the proposed order restricts this waiver to wells that will only produce from a spaced interval at a distance of more than 460 feet of the adjoining owner's lands. However, as was discussed in the October 21, 2013 Memorandum, the correlative rights protected by the Act is not just a right to the oil and gas beneath ones property. In fact part of the basis for this statement is due to the fact that what occurs beneath the ground within formations many thousands of feet below the surface may not be certain and depends on many technical factors that the Conservation Act seeks to address but in an imperfect and inperwise way. Thus correlative rights are defined as an '*opportunity*' to produce a 'just and equitable' share of oil and gas 'without waste'. *Hegerty v. Board of Oil, Gas and Mining*, 57 P.3d 1042, at 1050 (2002) emphasis supplied. This "opportunity" is protected by "authorizing the board to limit a land owners right to drill as many wells and in whatever locations on its land as the landowner chooses" *Cowling* at 225. "Once the Board fixes the size of the drilling units in a field 'the drilling of any well into the pool at a location other than authorized by the order is prohibited.' Utah Code § 40-6-6(4)". *Id.*

Thus, the existing the statutory scheme *and rules* have been established to protect the opportunity to develop and produce oil and gas (correlative rights) and are arguably an integral part of an owner's correlative rights. It follows that any modification in the rights that may affect the opportunity to produce a just and equitable share of the oil and gas without waste would affect a person's correlative rights. The right to notice and the right to consent or object to an adjoining well is arguably protective of this opportunity. Therefore, correlative rights are affected by deciding the rule is inapplicable. Notice is required to protect the owner's opportunity to produce a just and equitable share of oil and gas.

2. Requirements of the Utah Administrative Procedures Act and protection of rights of Due Process.

Does the administrative law require that an adjoining owner have a right to notice and participation in the spacing hearing where the requirement for consent may be determined to be inapplicable? If the right to consent is a right established by state agency action (even if it is determined not to be part of the person's correlative rights), then any suspension of that right is governed by the Utah Administrative Procedures Act (UAPA) and the person is entitled to notice and an opportunity for a hearing. UAPA applies to "state agency action that determines the legal rights, duties, privileges, immunities, or other legal interests of an identifiable person, including agency action to grant, deny, revoke, suspend, modify annul, withdraw, or amend an authority, right or license; and judicial review of the action. *See* Utah Code §63G-4-102(1)(a) and (2). Here the identifiable persons are those who own mineral within 460 feet of the well bore and the right being suspended is the right to consent to a well that is drilled directionally

within 460 feet or have a hearing. The state agency action is the suspension of that right by the Board as requested by Crescent.

3. Prior Orders.

In the Axia matter heard just last month, the Board denied a similar the request for waiver of the consent requirement for directional drilling for wells that would be located closer that the requested set back because the adjoining owners had not been given notice of the spacing hearing requesting the waiver. This case, although just heard establishes prior precedent, and the Board's order in this matter should be consistent with that decision for the same reasons.

B. Simultaneous Spacing and In-fill well approval.

This matter raises an additional issue that was not addressed in either the prior *Newfield* or *Axia* matters. The RAA seeks spacing on a 640-acre basis and simultaneously asks for infill drilling of up to 16 wells per section; a 40-acre equivalent. Small portions of these unspaced lands have been extensively developed under the general well siting rule allowing one well per 40-acre quarter-quarter section with forty-two (42) existing wells having been drilled.

The Board may apply an order establishing drilling units to additional unspaced lands upon evidence that the lands also overlay the same pool. (Utah Code § 40-6-6(6)(b)) In this case Crescent argues that the lands should be included in the 131-14 and 131-24 Orders that established a 640-acre drilling unit for adjoining lands because they overlay the same pool or common source of supply. Crescent also asks that it be allowed to infill with up to 16 wells per section or a 40-acre equivalent density. When lands have been spaced, the Board may (based upon proper evidence) allow for drilling of additional wells within the drilling unit. Utah Code § 40-6-6(6)(d) Production from the wells would continue to be shared on a section-wide basis.

In this matter, these lands have not been spaced and have been developed and are producing from wells located according to the 40-acre general siting rule. The production from each well has not been shared nor has the risk of drilling a well. The evidence submitted with the RAA suggests that one well can effectively and efficiently drain 40 acres but Crescent also argues that the size of areas drained by one well is not consistent throughout a section, and that sharing production based on a larger drilling unit size is necessary to economically develop the pool. Crescent has the burden of demonstrating why 640 acres and not 40 acres, or 160-acres would be an appropriate size for drilling units in this area.

While it is not unusual to allow infill drilling for already spaced areas, the simultaneous spacing and infill drilling requested by Crescent is unusual. It is also unusual due to the large difference between the requested size of the drilling unit and the equivalent spacing density that would result from infill drilling. Occasionally orders allowing for spacing with more than one well for a drilling unit is justified due to

physical constraints of topography or odd-sized sections as in the *Axia* matter decided in October, 2013. These situations may justify more than one well per drilling unit. Orders approving horizontal drilling units have also allowed for simultaneous approval of substantial numbers of additional wells, but this has usually been done on a pilot project basis with the understanding that the initial drilling will establish a more accurate spacing based on actual drainage area for one well. It has also been the pattern due to the fact that the general siting rule for horizontal wells is one section, even though more than one horizontal well is assumed to be necessary for such a temporary section-wide location.

The major argument in favor of the requested drilling unit, is the need to establish drilling units to establish a federal communitization agreement (CA) for the Indian minerals. The primary objection to such a simultaneous spacing and downsizing is the effect on the other owners in the lands to be spaced. As of the date of this memorandum no objections have been filed. Assuming there is no objection from land owners and that they either desire or are required to have a section wide spacing, this objection is not as important although the spacing does seem contrary to the statute and protection of individual owners correlative rights. As argued below there are advantages to having a drilling unit that more accurately reflects the engineering data and is less than a full section. If a smaller drilling unit satisfies the requirement for a CA, then it is a better result for other reasons including avoiding conflict over retroactive application of the spacing order.

3. Retroactive spacing.

Crescent also asks that the drilling unit order apply retroactively to the date of first production for existing wells within the spaced lands. This retroactive application is also alleged to be required by the federal rules governing communitization agreements. A comunitization agreement (CA) is similar to pooling, and the Utah Court has held that retroactive pooling prior to the date of a spacing order is illegal absent evidence of inequitable conduct. The Court held: “a pooling order should be effective no earlier than the *date of a spacing order*, unless there are special circumstances that would make it just and equitable for an order to be retroactive to protect correlative rights . . . from inequitable or overreaching conduct.” *Cowling v. Board of Oil, Gas, and Mining*, 830 P.2d 220, 229 (emphasis supplied). This language does not support using an effective date earlier than the date of the spacing order.

While it is true the RAA seeks retroactive *spacing* and *not retroactive pooling*, the purpose; i.e., to accommodate a CA is the same, and furthermore, the reasoning and rational for the decision in *Cowling* apply equally to retroactive spacing. The legal doctrine that is the foundation for the rule against retroactive pooling is the concept that correlative rights do not exist until the Board makes a determination of the size of a drilling unit “based on geologic and engineering evidence” presented at a hearing. As the Court said: “In short, under the Act, it is not possible to ascertain a landowners’ correlative rights until the Board acquires the necessary data in a formal hearing, makes findings of fact, and enters a spacing and drilling unit order.” *Cowling* at 226 The Court further stated: “Although a pooling order theoretically could be made retroactive to the

date of first production from an exploratory or wildcat well, even though that date is prior to the entry of a spacing order, *the Act* does not contemplate that result. Retroactivity of a pooling order under these circumstances would give adjoining interest owners correlative rights before those rights are defineable.” Cowling at 227, emphasis added.

As the court notes: “an owner’s failure to take action to establish and protect his or her interest in production prior to the entry of a spacing order constitutes a waiver of that interest until a drilling unit is established.” The *Cowling* case does not merely suggest that the prohibition against retroactive pooling is a matter of procedure, that can be overcome by retroactive spacing. Rather, retroactive pooling is contrary to the Act, since the Act requires an evidentiary hearing before correlative rights are established and prior to that date (absent inequitable conduct) the rule of capture applies. Since the decision states that there must be some inequitable conduct on the part of the unspaced owner in order to apply pooling retroactively against him, it follows that there must also be some equitable reason to apply spacing retroactive to the date of first production. In the matter before the board there is no inequitable conduct that would justify retroactive pooling. Therefore these owners should also not be subject to retroactive spacing that will lead to pooling by way of the CA.

Making spacing retroactive to the date of first production will be difficult to administer and could create hardships for those owners who took the risk to drill the wells. Owners of such wells would not receive any additional compensation or reward for their risk and expenditure of capital to drill wells. It is not clear from the request how the prior production will be accounted and repaid. Presumably those who have drilled a producing well on a 40-acre location will be required to payback an amount representing the portion of production received that will now be attributable to the other owners in the section. Perhaps they will be allowed to deduct that excess amount before receiving any payment from any additional wells to be drilled in the section. Unless production from the existing well is less than the average well production for the section such an owner would receive nothing, and may need to payout money from past production as a result of the retroactive spacing. There could be an obligation to pay interest on the over production received. This result flies in the face of their expectations when the wells were drilled. Absent retroactive application of a spacing order, those owners who have drilled prior to the entry of the order would not need to share their past production. see *Adkins v. Board of Oil, Gas, and Mining*. 926 P.2d 880 (1996).

Whether the federal law requires that the Board waive compliance with the Act’s prohibition against retroactive pooling and spacing is not a question that needs to be addressed² since applying 40 acres spacing avoids the problem. Forty acre or perhaps 160-acre drilling units rather than 640 acre units would eliminate or lessen the instances that may require retroactive spacing to comply with the federal rules, and would more correctly conform the drilling unit to the evidence of size of “the acreage that wells in the field can efficiently drain so as to maximize production.” *Cowling* at 227

² Crescent has the burden of demonstrating that there is a federal preemption. They have not presented any argument to that effect. If Crescent does make this argument, the Division asks leave to reply.

CONCLUSION

The Board should limit the request that the directional drilling (and exception location) rules be deemed inapplicable to all wells so long as they are completed in the spaced interval, to wells whose surface location is within the exterior set backs for spaced lands. The Board should not deem the rules inapplicable to locations that are closer than 460 feet of the exterior boundaries of the space lands since these owners have not been given notice of the request for waiver of the rule and are entitled to notice by virtue of the Act's obligation to protect correlative right or the UAPA requirements for notice and opportunity for a hearing when a right is waived.

The Board should also establish a drilling unit size for these unspaced lands that corresponds to the evidence of drainage as required by the Act. There is not a good reason to establish 640 acre sectional drilling units and it is contrary to the general requirements a drilling unit as set out in the Act. Orders that originally spaced land in this area on a sectional basis have been modified to allow greater density. The evidence filed with the RAA suggests that 40 acre spacing (the well density requested) or perhaps 160 acre spacing may be appropriate. Existing wells have been drilled under the 40 acre siting rule. Using smaller drilling units also avoids problems of retroactive pooling and accounting for production from the existing wells.

Although no owners have objected to application of the spacing order retroactive to the date of first production for existing wells, there is a serious question as to whether the Act as interpreted by the Utah court allows the Board to grant such a request. The intent is to form a CA that will effectively be similar to pooling of these lands and that result was rejected by *Cowling*. Perhaps federal law will preempt application of the Utah law.